MEMORANDUM FOR: Maurice

Attached is the Treasury draft discussing capital market liberalizations. This will be revised during an IG meeting Monday morning which

25X1 [redacted] will attend. The SIG on this subject will be on Friday, October 21; [redacted] will go with you.

25X1 [redacted]

Date 13 Oct 83

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OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

October 13, 1983

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| MEMORANDUM FOR | OVP | - MR. PHILIP HUGHES |
| | STATE | - MR. CHARLES HILL |
| | DEFENSE | - COL. JOHN STANFORD |
| | AGRICULTURE | - MR. RAYMOND LETT |
| | COMMERCE | - MRS. HELEN ROBBINS |
| | OMB | - MR. ALTON G. KEEL |
| 25X1 | CIA | - [redacted] |
| | USTR | - MR. DENNIS WHITFIELD |
| | OPD | - MR. LES DENEND |
| | NSC | - MR. ROBERT KIMMIT |
| | CEA | - MR. WILLIAM A. NISKANEN |
| | OCA | - MR. THOMAS GIBSON |

Subject: Next Meeting of Interagency Group on International Economic Policy (IG-IEP) to Discuss Japanese Capital Market Liberalization

Assistant Secretary Leland will chair a second meeting of the IG-IEP on Monday, October 17, to examine possibilities for liberalization of the Japanese capital market. Any written comments on the document distributed at the first meeting are requested by c.o.b., Friday, October 14. That document, your comments, and the attached supplementary pages to the document and executive summary of Lee Morgan's recent study of the yen/dollar exchange rate will be discussed on Monday.

The meeting will be held at 10:00 a.m., in Room 4426, Main Treasury Building. Attendance will be principal, plus one.

David E. Pickford

David E. Pickford
Executive Secretary

Attachments

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Revised

# THE MISALIGNMENT OF THE UNITED STATES DOLLAR AND THE JAPANESE YEN: THE PROBLEM AND ITS SOLUTION

## EXECUTIVE SUMMARY

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Dr. Ezra Solomon
Stanford University
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Dated: September 19, 1983

# A POSITIVE POLICY FOR EXCHANGE RATES

An extensive report recently completed by Professor Ezra Solomon of Stanford University and David C. Murchison of the Washington law firm of Howrey & Simon has confirmed that United States manufacturing firms and workers are suffering substantial injury as a result of a significant misalignment of the Japanese yen and the dollar. Entitled "The Misalignment of the United States Dollar and the Japanese Yen: The Problem and Its Solution," the study demonstrates that the misalignment of exchange rates is a major contributing factor to current distortions in U.S.-Japan trade patterns, including the record U.S. trade deficit, and suggests that early corrective action by both countries is essential to lasting economic recovery. Specific measures, consistent with the current policy of floating exchange rates and an open trading system, are recommended for bilateral examination and discussion.

## INTRODUCTION

Three variables relate the U.S. economy to the rest of the trading world:

1. Our trading balances with other countries. By any measure, these balances have deteriorated sharply since the end of 1980;

2. The dollar's exchange rate against other currencies. By any measure, the dollar has risen sharply and other currencies fallen since the end of 1980. In the process, the dollar has become seriously misaligned, especially against the Japanese yen; and

3. U.S. Government policies toward trade and exchange rates. Like other countries, we have an active policy on foreign trade. Within the framework provided by the GATT agreements, and sometimes without, the U.S. Government intervenes actively in markets to protect individual industries against competition from imports or to encourage exporting industries. In contrast, unlike other countries, we do not have a positive policy toward the exchange rate of the dollar. Present official policy is to accept the exchange markets passively in a spirit of "benign neglect."

Recent trends in the first two variables - notably the sharp and continuing rise of the dollar in the face of sharply rising trading deficits - clearly indicate the need for a re-examination of our unique indifference to the dollar's exchange rate as a policy variable. Specifically, two critical questions are involved:

1. Should U.S. policy be concerned about the fact that there is a serious exchange rate problem, especially between the U.S. and Japan?; and

2. If so, can U.S. policy be redirected to halt or reverse the trends of the past 2 1/2 years without sacrificing the other major objectives of national policy, namely, the pursuit of non-inflationary growth within the context of an open international trading system?

The answer to both questions is "yes." What follows is a summary of the analysis on which these two conclusions are based.

## U.S. TRADING BALANCES

Economic transactions between one nation and the rest of the world can be measured in many ways. By any measure, the U.S. balance deteriorated sharply between early 1981 and 1983.

As recently as the first quarter of 1981, the U.S. balance on non-petroleum merchandise trade (i.e., excluding petroleum imports and exports) was in surplus -- exports exceeded imports at a rate of $60 billion a year, or just over 2 percent of the U.S. gross national product. By the second quarter of 1983, this balance had shrunk to zero, and by July 1983, it was in the red. Statistically, the adverse swing of over $60 billion more than accounts for the entire fall in output and employment we suffered from the peak to the trough of the recent recession.

Three-quarters of the large adverse swing in our foreign trade balance was the direct result of a sharp deterioration in our balance of trade in manufactured goods. During the first quarter of 1981, the U.S. was a net exporter of manufactured goods at a rate of $20 billion a year. By the second quarter of 1983, we had become a net importer of manufactured goods at a rate of $28 billion a year. Over the same period, employment in the U.S. manufacturing sector declined by 10 percent or by around 2 million jobs. A substantial portion of that job loss can be blamed on the misalignment between the dollar and other currencies, most importantly the yen.

The current account balance, which includes not only goods but services and transfers as well, is widely regarded as the best single measure of a nation's international transactions, and as a major criterion for assessing the relative correctness of exchange rates. By this measure, the U.S. balance deteriorated sharply from a surplus of $12 billion a year in early 1981 to a deficit of $22 billion a year by year-end 1982. By mid-year 1983, the deficit reached a rate of almost $40 billion a year.

Since the early 1970s, the U.S. current account balance has swung into deficit in two previous periods, 1971-72 and 1977-79. Those deficits were accompanied by sharp declines in the dollar and appreciation of other currences which led to a restoration of equilibrium in our current account balance. The recent swing into deficit in 1981-83 has not been acompanied by a weakening of the dollar's exchange rate; instead we have witnessed a rising dollar and a depreciating yen, among other currencies.

## THE EXCHANGE RATE PROBLEM

The principal cause of the U.S. trade deficit is a misalignment between the dollar and other currencies, particularly the Japanese yen. The value of the yen has fluctuated in the ten years since the present system of floating rates was established. It recorded a peak of 175 yen to the dollar on October 31, 1978, and presently stands at approximately 244 yen to the dollar. At a level of 244 yen to the dollar, the yen is undervalued and the dollar overvalued.

Other currencies also have depreciated significantly vis-a-vis the dollar in recent years and, as a result, the dollar is misaligned against currencies besides the yen. The misalignment between the yen and the dollar, however, is of critical importance to the United States because of the unique intensity of competition between the United States and Japan:

1. Japan is our largest overseas trading partner, our largest foreign supplier, and we are her largest single market;

2. For the past ten years, the U.S. has run a chronic bilateral trade deficit with Japan, a deficit that has risen steadily from $2 billion a year in 1973 to around $20 billion a year in mid-1983. In the first quarter of 1983, our bilateral trade deficit with Japan alone accounted for about one-half of our total trade deficit; and

3. Past and current attempts to resolve imbalances between the two nations via trade policies instead of cooperative exchange rate policies have led to a growing list of trade frictions. Unless the misalignment between the dollar and the yen is resolved, these trade frictions are likely to grow more intense in the future.

It is possible to estimate the direction and approximate size of a currency misalignment. At a level of 244 yen to the dollar, the yen is seriously undervalued and dollar overvalued. A more realistic value would be approximately 200 yen to the dollar or stronger.

As a result of the yen-dollar misalignment, and the misalignment between the dollar and other currencies, foreign competitors have gained a significant pricing advantage in world trade. Thus, it is not surprising that all U.S. trading balances have deteriorated so sharply since early 1981. If the same trade effects had been achieved, not by misaligned exchange rates, but by the imposition of an additional foreign tariff against U.S. products or a foreign subsidy on shipments to this country, the authorities in charge of U.S. trade policy would have reacted strongly. Instead, the authorities in charge of U.S. exchange rate policy have done nothing except passively accept whatever was happening.

## THE THEORY OF BENIGN NEGLECT

Most trading nations regard the exchange rate of their currency as an important policy variable. The reason is obvious: employment and economic growth depend on trade and trading balances; these in turn depend on a nation's international competitiveness; competitiveness depends in large part on prices that a nation's customers have to pay; prices in turn depend on exchange rates.

The U.S. has been a notable exception to the almost universal rule of policy sensitivity to the importance of a nation's exchange rate. The reasons are partly historical and partly idealogical:

1. Relative to most other trading nations, the U.S. is a large continental economy and thus exports and imports have traditionally represented a small fraction of its economy. Although this condition no longer exists (exports and imports have both grown to be very much larger than they were two decades ago) it does provide certain insight into U.S. policy priorities.

2. Under the post-war Bretton Woods system of fixed rates, it was necessary for at least one national currency to play a passive role in the process of setting and maintaining the set of stated exchange rate parities. The U.S. dollar, as the central currency in that system, adopted this role. The name given to this view of its exchange rate policy was "benign neglect."

3. Most nations that suffer a serious current account deficit experience external as well as internal difficulties because those deficits have to be financed by capital inflows from other countries, and such financing is not always readily available. Witness the plight that developing nations with deficits have been facing lately. The U.S. in contrast, does not face external financing difficulties - as the world's most important reserve currency we simply issue a variety of dollar I.O.U.'s to other nations. Currently, for example, the U.S. is borrowing from the rest of the world at a rate far in excess of any other single nation.

But these historical reasons do not adequately explain the recent passivity of official U.S. exchange rate policy. Such passivity reflects a theoretical and idealogical preconception that any market-determined exchange rate is by definition the "right" rate. Thus, when the dollar traded for 175 Japanese yen in 1978 it was correctly valued; it was also correctly valued when it traded for 278 yen in 1982. In short, market rates are continuously correct rates because the market is efficient. This theory itself is "correct" only in the narrow sense that in a freely determined market system the dollar's exchange rate does reflect shifts in the relation between the total demand for dollars by holders of another currency versus the total supply of dollars from holders of dollars who wish to purchase other currencies. Given the preconception that the principal function of an exchange rate is to "clear the market" on a day-to-day basis, proponents of this view believe that it makes no sense either to argue that the dollar is overvalued or undervalued, or for the U.S. Government to try to correct any over-or under-valuation perceived by others.

## AN ALTERNATIVE VIEW

A second view, more widely held than the first, is that the prime function of exchange rates is to establish and maintain equilibrium among the national current accounts of the major trading nations. If a set of exchange rates that is generated by the market fails to serve this function for a particular country, it is entirely legitimate to conclude that its currency is misaligned (overvalued or undervalued) relative to its trading partners, and to require that active steps be taken to correct the misalignment.

It is in the second sense that a large and respected body of opinion holds that the dollar rate and the exchange rates of other major currencies are misaligned and that the most serious misalignment exists between the yen and the dollar. The two most important tests for a misaligned exchange rate are:

1. If prices in one currency rise more rapidly than corresponding prices in other trading currencies, the exchange rate of the first currency should fall in order to preserve equilibrium. If it does not fall or rises instead then the currency becomes overvalued relative to others. Between the fourth quarter of 1980 and the fourth quarter of 1982, U.S. prices and costs, by any measure, rose more than Japanese prices and costs. By this test, the yen should

have risen against the dollar by approximately 8 percent from a rate of 210 to a rate of 195 yen to the dollar; instead the yen has fallen against the dollar and presently stands at 244 yen to the dollar; and

2. If a nation's current account balance worsens markedly for no other identifiable reason it is a sure sign that it has an overvalued exchange rate.

It has been argued that special conditions in world markets might account for the deterioration in U.S. trading balances; the world as a whole has been in recession in 1981-83; the OPEC nations were suffering from a sharp drop in both the price and volume of their oil exports and hence had to cut back on their purchases from abroad; finally, the non-oil developing countries such as Brazil, Argentina and others were experiencing a financial crisis which forced them to trim their imports. All of this is true, but it does not explain why the U.S. current account balance worsened so sharply. During the same time period, Japan faced basically the same set of circumstances but managed to increase its trading surplus. Between early 1981 and mid-1983, Japan's current account position <u>rose</u> from a small deficit position of $2 billion to a surplus of $30 billion. During this same time period, West Germany also had a positive swing in its current account balance. Our negative swing of almost $50 billion, therefore, cannot be blamed on the common world market situation that each nation faced. We lost competitiveness primarily because of misaligned exchange rates.

The basic theory that underlies the functioning of a system of freely floating exchange rates, and hence that underlies our passive policy of benign neglect, requires that large changes in a nation's current account balance should induce an opposite change in that nation's exchange rate. In fact, both in the case of the U.S. and Japan, the two variables have been moving in the same direction since early 1981 - a clear indication that our exchange rate, and especially the yen-dollar rate, is no longer functioning as a mechanism for adjusting U.S. and Japanese current account balances. On the contrary, in both cases, exchange rate movements are acting perversely to accelerate rather than dampen the large swings that are occurring. In short, our policy of benign neglect is based on assumed theoretical relationships that are not valid, at least not in the case of the U.S. dollar and Japanese yen from 1981 to the present.

## CAUSES OF THE MISALIGNMENT

The present misalignment between the dollar and other currencies, most importantly the yen, in the face of large and rising U.S. trading deficits that are widely expected to rise even more, indicates that exchange rates have been driven by a third factor - namely, large autonomous net flows of capital into dollar assets, a significant portion of which is from Japan.

The net flow of capital into or out of a country is related to that country's balance on current account. A nation which runs a current account surplus such as Japan must, by definition, be exporting capital, <u>i.e.</u>, acquiring financial or tangible assets abroad. This is so because the total "balance of payments" must balance, <u>i.e.</u>, total inflows including capital flows must equal total outflows. Conversely, a nation which runs a current account deficit such as the U.S. must be importing capital.

Normally, the trading transactions that comprise the current account are autonomous and the corresponding capital flows are simply accomodative. In the case of the U.S. since 1980, these normal patterns no longer hold. The net capital inflows into dollar assets are autonomous; they increase the overall demand for dollars and thus drive up the dollar's exchange rate and drive down the exchange rate of the yen and other currencies. This, in turn, prices many U.S. goods out of the market both at home and abroad, thereby plunging the U.S. current account balance into a deficit position. The large foreign demand for dollars and dollar denominated securities as <u>financial assets</u> is the principal reason for the present currency misalignment, and thus the principal reason for the relatively weak demand for products produced by dollar-based factories and farms.

Undoubtedly, high United States interest rates have contributed to the flow of capital into this country. However, a number of Japanese Government policies have had the effect of encouraging the outflow of capital from Japan and thus weakening the yen. Other measures in Japan have served to reduce the demand for yen.

## THE FAVORABLE CONSEQUENCES OF MISALIGNED EXCHANGE RATES

It has sometimes been argued by proponents of passive policies that even if the "system" may not be working as envisioned by theory, the existing state of affairs (including an overvalued dollar and an undervalued yen) is nonetheless satisfactory for two reasons, other than the obvious one that foreign goods and services have lower dollar prices than would be true with a lower capital inflow.

The first reason is that net capital inflows into the U.S. provide necessary and welcome help in financing our budget deficit. The second reason is that the overvalued dollar provides the necessary pressure for U.S. industry to weed out weaker plants (and industries) and to force stronger businesses to become more cost-efficient in order to compete.

Both arguments are unsound. First, the world's richest economy does not need, and should not require, other nations to finance its budget deficit. Second, although international competition is always basically desirable, the huge cost handicap to U.S. industry imposed by the dollar's effective exchange rate, especially as against the yen, represents an impossible burden that even our most efficient industries cannot overcome. Furthermore, both arguments ignore the serious permanent damage that the continuing (and worsening) misalignment of the dollar's exchange rate imposes on the U.S. and the rest of the free world.

## THE ADVERSE CONSEQUENCES OF MISALIGNMENT

The emergence of increasingly misaligned exchange rates and the continued passivity of our own policy towards this development have serious adverse consequences for the U.S. and potentially for our trading partners:

1. The ability of a wide range of U.S. industries to compete both here and in overseas markets has been impaired. The loss of markets has led to the loss of jobs and to the shut-down of plants. Unless promptly corrected, these losses will become permanent;

2. If the loss of competitiveness caused by the exchange rate misalignment is not corrected by exchange rate policies, U.S. industry, including management and labor, will undoubtedly seek to cure it by artificial means such as tariff and non-tariff barriers against imports, and direct and indirect subsidies for exports. There have already been a number of moves in these directions, and there is widespread apprehension both here and abroad that a presidential election year will intensify the pressures for protectionist policies. At a minimum, such moves will lead to increasing frictions with our trading partners, particularly Japan. At worst, they could lead to a substantial breakdown of the open international order that has served the free world so well for the past thirty years; and

3. Our passive exchange rate policy in the face of a rising net inflow of capital into dollar assets also entails other adverse consequences for the U.S. and the rest of the

world. It creates a drag on U.S. output and employment; it leads to a growing foreign debt for the nation; it deprives developing nations of capital they badly need, and the consequent slowing of growth in the U.S. and elsewhere deprives the developing countries of the growing export markets they need in order to service their burdensome foreign debts.

## A POSITIVE EXCHANGE RATE POLICY

Much of the actual and potential economic pain being caused to the U.S. by misaligned exchange rates is unnecessary because it can be solved by replacing our present passive exchange rate policy with a positive policy toward exchange rates. Furthermore, it can be done without abandoning our dedication to open markets and the free international flow of goods, services and capital.

Given the problems arising from a misaligned dollar, especially against the yen, and further that the increasing degree of dollar-yen misalignment is being driven by net capital flows into dollar assets, it follows that these problems can be corrected, or at least reduced, by measures which increase world demand for yen assets and/or reduce world demand for dollar assets. Such steps should, of course, be taken in concert with the Japanese Government. Some of the steps required to reduce the attraction of dollar-denominated assets to foreigners are steps that we should take unilaterally for their own sake, *i.e.*, steps to reduce dollar interest rates and to correct those factors that have kept dollar interest rates high, such as the size of the federal budget deficit and the persistence of apprehensions about future inflation.

In addition, there are several additional remedies available if policymakers, particularly in the U.S. and Japan, recognize and act on the basis of three propositions:

1. There is a serious exchange rate problem, especially between the U.S. and Japan;

2. The principal cause of the problem lies not on the trade side of the equation but on the side of capital flows in that the dollar-yen exchange rate and other dollar exchange rates have been driven up by huge net capital flows out of Japan and Europe into the dollar; and

3. Steps to reduce these net flows by cooperative shifts in governmental policies can and should be taken to reduce the dollar's worsening overvaluation and the yen's undervaluation.

## SUGGESTED REMEDIES

Assuming a U.S.-Japan agreement on objectives, the following actions are available which will lower the dollar's exchange rate, particularly against the yen, by increasing the overall demand for yen and yen-denominated assets and reducing the overall demand for dollars and dollar-denominated assets. President Reagan's forthcoming visit to Japan would be an ideal time to present the following suggested list of specific measures to the Japanese Government:

1. A clear expression by the U.S. and Japan that a serious exchange rate misalignment exists and that the two governments intend to work together to initiate corrective action, first on their own and later with the cooperation of the wider international community;

2. Purchases of yen by the Federal Reserve Board in open-market transactions and in amounts consistent with existing monetary targets. Over the past 12 months, the Federal Reserve System, in conducting its open market operations for purposes of implementing its chosen monetary fund targets, purchased around $15 billion of U.S. Government securities. In the coming year, the Federal Reserve Board could allocate one-half of its desired total purchases into yen-denominated government securities without compromising its policy goals;

3. Japanese Government action to convert into yen an equivalent number of dollars out of its large holding of dollar reserves;

4. Eventually, similar action by other major official holders of dollars such as West Germany, Saudi Arabia and Kuwait;

5. An increase in the Government of Japan's overseas borrowing with the proceeds converted immediately into yen to assist Japan in financing its substantial budget deficits;

6. A substantial increase in the percentage of Japanese trade that is financed in yen. Japanese importers and exporters (who jointly trade about $300 billion a year) now denominate a very high fraction of their invoices in U.S. dollars, thus increasing the demand for dollars. A shift in such practices toward yen denomination will reduce world demand for dollars and increase world demand for yen;

7. Removal of any administrative guidance restrictions which prevent full implementation of the new Japanese FOREX law;

8. Definite and specific measures by the Japanese Government to remove artificial curbs on the demand for yen, including:

(i) removal of interest rate controls on deposits, debentures and government bonds;

(ii) removal of constraints on short-term financial instruments such as call market, bill market, Gensaki market and certificates of deposit and expansion of the Treasury bill market;

(iii) removal of restrictions on yen-dollar swaps;

(iv) removal of withholding tax on non-resident interest earnings;

(v) removal of restraints on Eurobond issues; and

(vi) action by the Japanese Government to permit the development of an offshore banking facility;

9. The Japanese Government could take steps to increase the flow of Japanese savings into the recessed Japanese housing market;

10. Joint U.S.-Japan action to encourage other central banks which hold a significant amount of their reserves in dollar assets and virtually none in yen assets to buy yen and sell dollars. A $15 billion shift in the dollar-yen composition of these portfolios would increase the demand for yen and reduce the demand for dollars by $15 billion; and

11. The International Monetary Fund should review the existing misalignment of the yen and the dollar and recommend further ways to reduce the existing imbalance.

For several reasons, the Japanese Government should cooperate in a program which will result in the strengthening of the yen vis-a-vis the dollar. First, the Japanese have an interest in preserving the present international trading system based on free trade. Second, the Japanese should be receptive to a policy which would decrease the ouflow of capital from Japan because the Japanese economy will face severe credit problems in 1984, when the first issue of 10-year government bonds is scheduled to mature at the same time that the government will have to increase borrowings to finance its large current budget deficits. Third, allowing the market mechanism to establish interest rates also will benefit Japan by allocating capital resources more efficiently. Fourth, the free flow of capital between the United States and Japan also will benefit overall world growth which will, in the long-term, benefit Japan.

Taken together, these and other available actions provide the basis for a positive corrective policy by both governments toward the now-misaligned yen-dollar rate. Such a course of action provides an appropriate and far more desirable basis for correcting the growing trade problems between two friendly nations than is available via tariff and non-tariff barriers.